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CPI Competition Policy Institute

April 8, 1997

Chairman Reed Hundt
Commissioner James Quello
Commissioner Susan Ness
Commissioner Rachelle Chong
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20006

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Federal Communications Commission
Office of Secretary

Re: *Ex Parte Communication -- CC Docket No. 96-262*

Dear Mr. Chairman and Commissioners:

A number of local exchange carriers (LECs) have argued that prescriptive reductions in access charges are legally impermissible. They make two arguments: first, that prescriptive reductions in access charges would violate the Takings Clause of the U.S. Constitution and, second, that prescriptive reductions would violate a so-called "regulatory contract" with the government.

The Competition Policy Institute (CPI), with the assistance of the law firm of Covington & Burling, has undertaken a legal analysis of the arguments raised by the LECs. Our analysis yields the following results: *First*, the Commission may prescribe reductions in access charges to forward-looking costs without effecting an unconstitutional taking. The Constitution does not constrain the use of any particular ratemaking scheme, such as the use of forward-looking costs, because it is the end result, not the methodology, that determines whether a "taking" has occurred. Since the LECs would continue to receive compensation from a variety of services, including access services at forward-looking costs, the "end result" of prescribed access charge reductions is that the LECs will continue to be financially viable and thus cannot succeed with a takings claim. *Second*, the LECs have no right to guaranteed recovery of their historical costs pursuant to a so-called "regulatory contract." The LECs have no such contract with the Commission as a factual matter, and any claim based on such a contract would be barred by a number of legal doctrines designed to protect the government's sovereign powers of regulation.

In sum, we find that the LECs' legal arguments against the prescriptive access charge reductions are without foundation either in the Supreme Court's takings precedents or in contract law.

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1156 15th Street N.W., Suite 310 • Washington, D.C. 20005 • 202-835-0202 • Fax: 202-835-1132
3773 Cherry Creek North Drive, Suite 1050 • Denver, Colorado 80209 • 303-393-1556 • Fax: 303-321-1248

The following legal memorandum provides a more detailed discussion of the relevant Supreme Court decisions on these issues and responds to the specific arguments raised by the LECs.

Pursuant to rule 1.1206(a)(1), two copies of this letter and the attached Memorandum are being submitted to the Secretary for inclusion in the record of this proceeding.

Sincerely,

John Windhausen, Jr.

John Windhausen, Jr.
General Counsel

CPI Competition Policy Institute

April 8, 1997

LEGAL MEMORANDUM

OF THE

COMPETITION POLICY INSTITUTE

CONCERNING THE LEGAL AUTHORITY OF THE

FEDERAL COMMUNICATIONS COMMISSION

TO PRESCRIBE REDUCTIONS IN ACCESS CHARGES

CC DOCKET NO. 96-262

A number of local exchange carriers (LECs) have argued that prescriptive reductions in access charges are legally impermissible. They make two arguments: first, that prescriptive reductions in access charges would violate the "Takings Clause" of the U.S. Constitution and, second, that prescriptive reductions would violate a so-called "regulatory contract" with the government.

The Competition Policy Institute (CPI), with the assistance of the law firm of Covington & Burling, has undertaken a legal analysis of the arguments raised by the LECs. The following legal memorandum reviews the relevant case law governing the law of takings and the "regulatory contract". While it is impossible to predict in advance exactly how a court would rule if the LECs challenge a prescriptive reduction in access charges, we conclude that Supreme Court precedent makes it extremely unlikely that the LECs would prevail in such a challenge.

This Legal Memorandum addresses, first, the law concerning regulatory takings and, second, the regulatory contract theory raised in the affidavit of Sidak and Spulber attached to the comments of the U.S. Telephone Association in this proceeding.

I. The Takings Argument

A. The Constitution does not prohibit the Commission from prescribing access charge reductions based on a forward-looking cost methodology.

As the Commission well knows, the constitutionality of ratemaking orders -- such as those prescribing methods for calculating access charges -- is governed by the Supreme Court's decision in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). There, the Court held that

> [I]t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry . . . is at an

> end. The fact that the method employed to reach that result may contain infirmities is not then important.

Id. at 602 (emphasis added); *see also Wisconsin v. FPC*, 373 U.S. 294, 309 (1963).

The Court recently reaffirmed this finding in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989). In *Duquesne Light,* the Court upheld a Pennsylvania law that prevented an electric utility from recovering its historic investment costs, even though the investment was deemed prudent and reasonable when made. In reviewing the evolution of Supreme Court jurisprudence on ratemaking cases, the *Duquesne Light* Court noted that, for a time, some Justices supported, as "the constitutional minimum, what has become known as the 'prudent investment' or 'historical cost' rule." 488 U.S. at 309. The Court then asserted, however, that the argument that the Constitution mandates a particular rate methodology was rejected in *Hope Natural Gas*. "[T]he economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties." *Id.* At 314. The Court concluded that "[t]he designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors." *Id.* At 316 (footnote omitted).

As a result, the LECs cannot succeed in a taking claim based simply on the imposition of a different cost methodology.

B. The "total effect" of prescribing access charge reductions based on forward-looking costs would not constitute a taking.

Although *Hope Natural Gas* and its progeny do not allow constitutional challenges to any particular methodology, they *do* permit challenges to a particular rate or rates. Whether a particular rate or rates are found to be an unconstitutional taking is primarily a factual, not a theoretical inquiry. The effect of that method on the "financial integrity" and investment-backed expectations of particular firms, will all vary from case to case, and what may be a confiscatory effect as to one firm may not be with respect to another.[1]

Thus, it is impossible to predict in advance whether a particular rate would effect a taking on a particular company. Nevertheless, there are several reasons to believe that the courts, when reviewing the facts, would not find a prescriptive reduction in access charges based on forward-looking costs to be confiscatory even if the amount of the reduction is substantial.

First, the Supreme Court has taken a highly permissive approach to the facts. In *Duquesne Light*, for example, the Court acknowledged that the "used and useful" methodology adopted by Pennsylvania, which removes from the rate base costs incurred for investments that are not "used and useful" to ratepayers, would result in a "loss to utilities from prudent but

[1] The Supreme Court stated that determining how far a regulation can go before it imposes a taking involves "essentially ad hoc, factual inquiries." *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978).

ultimately unsuccessful investments," and that such a loss "increases the overall risk of investment in utilities . . . ." 488 U.S. at 312 n.7. Nonetheless, the Court concluded that the chosen methodology, viewed from its total effect, was constitutionally valid. "The Constitution within broad limits leaves the [ratemakers] free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public." *Id.* At 316.

The facts in *Duquesne Light* are particularly analogous to the access charge issue. In that case, the Court upheld the shift to a "used and useful" test even though the regulators applied the test to investment that had been incurred prior to the regulators' adoption of the new standard. Furthermore, application of the "used and useful" test requires the regulators to adopt a forward-looking approach similar to that required by the TSLRIC standard proposed by the FCC.[2/]

Second, in *Hope Natural Gas*, the Supreme Court indicated that a takings challenge depends upon whether the "total effect" of the government's regulation is confiscatory. The question of whether a prescriptive reduction in access charges harms the financial integrity of the firm depends upon many other factors. For instance, detrimental effects of the Commission's prescriptive reduction of access charges may be exceeded by the benefits to the LECs of stimulated overall demand for local and long distance telephone service (as well as the Bell Operating Companies' opportunity to enter the long distance market). The decisions by the FCC and by the States to create universal service funds to subsidize certain high-cost services will also affect each firm's economic condition. Further, unlike the electric utility in *Duquesne Light Co.*, LECs are multi-product firms which can earn a return on their networks in a number of different ways. The financial integrity of the telephone companies depends upon the amount of revenues they may earn from special access services, local exchange services, directory publishing, video services (cable or open video systems), and other unregulated services and investments.

Third, the regulatory takings cases make clear that, even where regulation destroys all economic value of the property, the determination of whether a taking has occurred "necessarily requires a weighing of private and public interests." *Agins v. City of Tiburon*, 447 U.S. 255, 260 (1980). A long line of cases establishes that the government may take action that destroys all economic value of a property if taken pursuant to the "health, safety, morals, or general

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[2/]Similarly, in *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978), New York City had forbidden construction of a 53-story office building atop Grand Central Station on the ground that the plan would destroy the historical and architectural value of the landmark. The Supreme Court found that this action did not constitute a taking, for the following reasons: the law did not interfere with Penn Central's primary use of the building as a railroad terminal; not all development was categorically prohibited; and the City compensated Penn Central by giving it certain valuable transferable development rights. The analogy to access charges would be as follows: even if the FCC prescribes significant reductions in access charges, the LECs will continue to provide local exchange and exchange access services; they will continue to be allowed to invest in their network and in new lines of business; and the LECs will receive significant compensation for providing access services (albeit at lower rates) and, to the extent necessary, from universal service funds.

welfare".[3] In *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1015 (1992), 505 U.S. at 1027, new legislation governing the use of beach-front property had the effect of depriving the owner of a beachfront lot all economically viable use of his land. The Court could not find a taking until it considered whether the limitations on the use of the land -- grounded in state law nuisance principles -- were inherent in the background legal regime which defined the limits of the property right in the first place. Thus, even where it is acknowledged that regulation destroyed all economically viable use of the land, the Rehnquist Court considers it still a difficult question whether relief should be granted.

In other words, it is not enough for the LECs to show that the prescription of forward-looking costs causes them severe financial hardship. The courts will also balance the harm to the petitioners with the purposes of the regulation and its benefits to the public. In this case, for instance, the court would be required to examine the public's interest in receiving lower long distance rates, the efficiencies of pricing access at their most economic level, and the requirements of the Telecommunications Act of 1996 and the possibilities of RBOC entry into long distance.

Further, the LECs' taking arguments would have to proceed against the background legal regime that involves extensive regulation of the LECs' operations at the federal and state level. In this case, the courts are likely to be persuaded that the LECs, and their investors, have conducted their operations with the full understanding and expectation that their rates would be subject to regulatory review, and could deny a takings challenge for this reason alone.

One final point deserves mention: The cases often cited to support a regulatory takings generally involve government regulations, such as zoning or environmental regulations, that deprive a property owner of the right to make some economically valuable use of that property. There are very few takings challenges to rate regulation decisions. In fact, **the LECs have not cited, and we are not aware of, a single case in which the federal courts have found a taking involving rate regulation since *Hope Natural Gas*.**[4]

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[3] *Penn Central Transp. Co.*, 438 U.S., at 125. *See also*, *Mugler v. Kansas*, 123 U.S. 623 (1887) (upholding an ordinance prohibiting operation of a previously lawful brewery); *Goldblatt v. Hempstead*, 369 U.S. 590 (1962)(upholding a town regulation that barred continued operation of an existing sand and gravel operation in order to protect public safety).

[4] The LECs' "physical occupation" argument adds nothing to their claims under *Hope Natural Gas*. This proceeding contemplates regulation of charges, not occupation of the LECs' property. The LECs' argument is thus more relevant to physical collocation or pole attachments. Extending the "physical occupation" rationale to ratemaking, moreover, calls into question the entire enterprise of common carrier regulations; common carriers, after all, are almost always required to open their facilities to the public at regulated rates. The "physical occupation" claim thus collapses into the LECs' claim under the ratemaking cases.

II. The Regulatory Contract Argument

The centerpiece of the LECs' argument in this proceeding is an elaborate theoretical construct, based on a law review article by J. Gregory Sidak and Daniel F. Spulber,[5/] called a "regulatory contract." Whatever value this contractual metaphor may have as a political argument, it has little foundation in the law. The LECs have fallen far short of demonstrating an enforceable legal obligation under the common law of contracts. Further, the LECs' argument fails to take adequate account of the "unmistakability doctrine", the doctrine that requires applicants to demonstrate that the sovereign government agreed to bind itself in "unmistakable" terms. In the end, the LECs' "regulatory contract" argument is an interesting theory -- but no more than that.

In order to establish a claim under the regulatory contract theory, the LECs must overcome all three of the following legal doctrines recognized by the Supreme Court: first, the LECs must demonstrate that the FCC has in unmistakable terms the legal authority to bind itself to a contract; second, the LECs must demonstrate in unmistakable terms the existence of a contract with the FCC; and third, the LECs must demonstrate in unmistakable terms that the contract guarantees the LECs recovery of their historic costs. Sidak and Spulber fail to demonstrate that any of these three prongs is satisfied.

A. Under the "express delegation" doctrine, the FCC has no authority to bind itself to a contract.

Under the express delegation doctrine, any delegation to an agent -- such as the Commission -- of powers to enter into a contract constraining the sovereign power must be set forth in unmistakable terms. This doctrine arises from circumstances uncannily similar to the present ones. In *Home Telephone & Telegraph Co. v. City of Los Angeles*, 211 U.S. 265 (1908), a local telephone company challenged a municipal ordinance fixing rates for local phone service as inconsistent with its franchise agreement with the City. The Court rejected this challenge on the ground that the State had not delegated to the City the power to make contracts precluding future regulation; "for the very reason that such a contract has the effect of extinguishing *pro tanto* an undoubted power of government," the Court said, "both its existence and the authority to make it must clearly and unmistakably appear, and all doubts must be resolved in favor of the continuance of the power." *Id.* at 273 (citations omitted). In other words, the Court in *Home Telephone* reaffirmed the presumption that the local municipality only has the powers that it has been given by the State. Since the State had not delegated authority to the city to bind itself against changes in its regulations, the city had no authority to so bind itself. Thus, the city retained the right to alter its regulatory course even after entering into a contractual agreement with the telephone company.

[5/] *See* J. Gregory Sidak & Daniel F. Spulber, "Deregulatory Takings and Breach of the Regulatory Contract," 71 N.Y.U. L. Rev. 851 (1996), recapitulated in Affidavit of J. Gregory Sidak and Daniel F. Spulber, attached to USTA Initial Comments (Jan. 29, 1997).

No provision in the Communications Act expressly delegates to the FCC the power to bind Congress not to alter the regulatory arrangements affecting access charges, or to bind the Commission itself not to shift to a forward-looking rate methodology. In other words, even if the LECs could successfully prove the existence of a contract and a provision guaranteeing them recovery of their historic costs, they have not shown that such a contract is enforceable. They have not demonstrated that Congress delegated to the FCC the power to bind itself to a particular regulatory regime. Thus, the sovereign power of the FCC to alter its regulatory methods continues to rest with the FCC.

B. The LECs have no contract with the Commission.

Sidak and Spulber assert that "[t]he regulatory contract is recorded in a bundle of documents not necessarily limited to a single franchise agreement: public utility statutes, utility commission precedents, adjudicatory decisions, rulemakings, hearings on the record, formal notices of proposed rulemaking, and public commentary." Aff. at 46. But their affidavit fails to analyze these materials or to identify *any* specific evidence of a contract between the LECs and the Commission. Instead, they appear to argue that any mutually beneficial regulatory relationship is contractual in nature.

The "regulatory contract" theory derives from a line of cases, beginning with *Charles River Bridge v. Warren Bridge*, 36 U.S. (11 Pet.) 420 (1837),[6] concerning franchises granted by state or local governments. Such a franchise "was a legal instrument -- a contract having all the constitutional protection that a contract between private parties would enjoy." Sidak & Spulber, 71 N.Y.U. L. Rev. at 899. Sidak and Spulber accordingly acknowledge that "the original franchise agreement between the public utility and a municipality is usually the critical first document in the bundle of agreements concerning the relationship between the state and the utility." Aff. at 46. The problem for the LECs, of course, is that the FCC does not issue franchises to local exchange carriers. **In other words, neither the Commission nor any other arm of the Federal Government is a party to any "critical first document" that would establish the existence of such a regulatory contract.**

The LECs attempt to infer the existence of a contract in two ways. First, they argue that the jurisdictional separations process described in Part 32 of the Commission's rules is "a modification of the regulatory contract" which has the effect of "interpos[ing] the federal government (represented by the FCC) as a party to the preexisting contract between the state and the LEC." Aff. at 104-05. But nothing in the separations process purports to be a contract, or a modification of a contract. Rather, the process simply allocates regulatory *authority* pursuant to the mandate of 47 U.S.C. § 152(b). To be sure, the separations process does facilitate *regulation*

[6] *See also West River Bridge Co. v. Dix*, 47 U.S. (6 How.) 507 (1848); *The Binghamton Bridge*, 70 U.S. (3 Wall.) 51 (1865); *New Orleans Water-Works Co. v. Rivers*, 115 U.S. 674 (1885); *New Orleans Gas Co. v. Louisiana Light Co.*, 115 U.S. 650 (1885); *Walla Walla City v. Walla Walla Water Co.*, 172 U.S. 1 (1898); *Detroit v. Detroit Citizens' Street Railway Co.*, 184 U.S. 368 (1902); *see generally* Aff. at 35-37 (discussing these cases).

of the LECs by the federal government. As in *Winstar* (discussed below), however, it takes something more to transform pure regulation into a mutual contractual obligation.[7]

Second, the LECs appear to assert that federal access charge reform -- an interstate issue -- would breach the *intra*state regulatory contract by creating a revenue shortfall for which intrastate revenues could not compensate. *See id.* at 105-06. This contention cannot withstand scrutiny. What the LECs have described is simply a situation -- familiar in contract law -- where a subsequent change in the governing law has made it impossible for one party to perform under the contract. Hence, while the LECs may be able to assert that the State has breached its contract (assuming *arguendo* that it exists at all) by not permitting the LEC to recover all of its historical costs, the State will be able to defend on the ground of impossibility. In other words, the State would argue that it cannot compensate for all the LECs' historical costs because a portion of those costs were assigned to the interstate jurisdiction, over which the States have no control. In that instance, the loss will remain where it falls unless the LECs can prove that the parties foresaw the risk of legal change and allocated it differently in the contract. *See, e.g.,* Restatement (Second) of Contracts § 261. That federal regulation may have such impacts, however, has never been found to make the federal government a party to contracts or to bar the sovereign's power to change the law.[8]

C. Even if a contract exists, the government did not guarantee the LECs the right to recover their historical costs.

Even if the LECs could demonstrate that a regulatory contract exists, they would still have to show that regulators specifically guaranteed them the right to recover all of their historical costs. That right is not explicitly set forth either in the state-granted license or in the federal/state separations procedure -- the only two documents to which the LECs have specifically pointed as embodying a regulatory contract.

In fact, a guarantee of historical costs would be inconsistent with the Commission's past adoption of both a "used and useful" standard for access charges, *see* Amendment of Part 65 of

[7] The LECs might also point to § 214, which requires all common carriers, including carriers not subject to price regulation, to obtain Commission approval for the construction or extension of lines based on a finding of public convenience and necessity, as evidence of a "regulatory contract" between them and the Commission. A long line of FCC cases, however, establishes that FCC approval under Section 214 does not guarantee the common carrier a return on its investment, nor does it provide any assurance on economic performance. *See, e.g., Common Carriers -- Competition for Specialized Services* 22 RR2d 1501 (1971), aff'd sub nom. *Washington Utilities & Transp. Comm'n v. FCC*, 513 F.2d 1142 (9th Cir.), *cert. denied* 423 U.S. 836 (1975); *Pacific Telecom Cable, Inc.*, 66 RR2d 793 (1989); *Mackey Radio and Tel. Co., Inc.*, 19 FCC 1321, 1350 (1955), aff'd sub nom. *RCA Communications, Inc. v. FCC*, 238 F.2d 24 (D.C. Cir. 1956).

[8] While the LECs might be entitled to a restitution remedy if the States' performance becomes impossible, *see* Aff. at 72-74, they wrongly suggest that this remedy would be measured by their *reliance* interest in their sunk costs. It is hornbook law that restitution is measured by the benefit actually incurred upon the other party. *See, e.g.,* Restatement (Second) of Contracts § 371. Hence, the LECs would be entitled to restitution of their historic costs only to the extent that past benefits to consumers exceeded the compensation that the LECs had already received.

the Commission's Rules To Prescribe Components of the Rate Base and Net Income of Dominant Carriers, *Report and Order*, 3 FCC Rcd 269, 269 (1987), and a price cap regime for the largest LECs, *see* LEC Price Cap Order, 5 FCC Rcd 6786 (1990). In adopting price cap regulation, the Commission rejected "cost-plus" rate of return regulation and instead embraced an "incentive" system that creates doubt, at least in theory, whether a LEC would generate sufficient revenue to recover all of its costs. In adopting its price cap plan, the Commission stated that, if a carrier fails to introduce efficiencies and reduce costs, then "carriers' profits are likely to be below current authorized levels."[9/] The FCC's introduction of "risk" in the ability of LECs to recover their costs makes it difficult for the LECs to sustain an argument in 1997 that the Government has guaranteed them a certain cost recovery level.[10/]

The LECs can point to no explicit agreement here modifying the background presumption that they are entitled only to the "fair" return required by *Hope Natural Gas*.[11/] The regulatory contract argument thus collapses into the LECs' takings claims. The unrebutted background presumption is that any regulatory contract mandates only a "fair" return, and we have demonstrated above that such a return need not always include historical costs.[12/]

D. The unmistakability doctrine forecloses arguments of an implied contract.

As shown above, the LECs fail to produce any explicit document setting forth a contract between the LECs and the Federal Government, and they fail to produce any record of a "guarantee" or "promise" that their historical costs would be recovered. These gaps are especially harmful to the LECs' case given that the "unmistakability doctrine" imposes a high hurdle on any entity seeking to enforce contractual rights against the government.

The "unmistakability doctrine" is a longstanding presumption against construing governmental actions to create contractual obligations that implicate the government's sovereign powers. The LECs' contract claim implicates the government's sovereign powers; in essence, the LECs have argued that their relationship with regulators -- both state and federal -- must be interpreted as foreclosing the Commission's ability to adopt some other ratemaking methodology,

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[9/] *LEC Price Cap Order*, Supplemental NPRM, 5 FCC Rcd 2176, at para.3 (1990).

[10/] The LECs' argument that the Commission has guaranteed them a certain cost recovery level is weakened even further by the fact that they endorsed the Commission's price cap plan.

[11/] A prudency review process, in which an investment is determined up front to be prudent, may prompt some to argue that the utility is entitled to a return on its investment. But this was *not* enough for the Supreme Court in *Duquesne Light Co. See* 488 U.S. at 301.

[12/] The LEC's claim of violated expectations is, in any event, overblown. Their own counsel have acknowledged that "by the early 1980s the Bell System had accumulated a vast library of accounting books that belonged alongside dime-store novels and other works of fiction. The books grossly overvalued assets. . . . By 1987, it was widely estimated that the book value of telephone company investments exceeded market value by $25 billion dollars." Michael K. Kellogg, *et. al*, *Federal Telecommunications Law* 477-78 (1992). Thus, it is difficult to see how the LECs could realistically have expected to recover all of their historical costs.

such as forward-looking methodologies, without compensating the LECs for their historical costs. The LECs' claim is therefore subject to the unmistakability doctrine, which holds that

> "sovereign power . . . governs all contracts subject to the sovereign's jurisdiction, and will remain intact unless surrendered in unmistakable terms" . . . Therefore, contractual arrangements, including those to which a sovereign itself is party, "remain subject to subsequent legislation" by the sovereign.

Bowen v. Public Agencies Opposed to Social Security Entrapment, 477 U.S. 41, 52 (1986) (quoting *Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130, 147, 148 (1982)).[13/]

The Supreme Court considered the unmistakability doctrine most recently in *United States v. Winstar* 116 S.Ct. 2432, Slip op. (1996). While the Court in that case ultimately found for the plaintiffs, the case provides no support to the LECs for at least two reasons: First, the facts of that case differ significantly from the access charge proceeding. Second, the Court failed to produce a clear opinion. Justice Souter's plurality opinion (for four justices) held that the contracts did not implicate the government's sovereign powers, and that therefore the unmistakability doctrine did not apply. Justice Scalia's concurrence (for three justices) held that the unmistakability test *was* applicable, but that it had been satisfied.[14/] Although it is unclear which approach will ultimately command a majority on future cases, it is clear that *each* would bar the LECs' "regulatory contract" claims.

Winstar involved a suit for contract damages by the owners of several thrift institutions based on agreements entered into by thrift regulators during the savings and loan crisis of the 1980s. In essence, the Federal Savings and Loan Insurance Corporation (FSLIC) had asked certain healthy thrifts to acquire (and assume the liabilities of) various failed thrift institutions in transactions called "supervisory mergers." The FSLIC assured the acquiring thrifts that they would be allowed to count the difference between the acquired institution's liabilities and assets as a paper asset called "supervisory goodwill," and to count that asset toward the capital reserves which all thrifts were required by federal law to maintain.

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) subsequently banned the use of supervisory goodwill toward federal reserve requirements, with the result that many of the acquiring thrifts were rendered immediately insolvent and taken over by federal regulators. The acquiring thrifts sued the United States for breach of contract, asserting that federal regulators had *guaranteed* them the right to use supervisory goodwill.

[13/]The unmistakability doctrine originates in the same line of nineteenth century franchise cases upon which the LECs rely for their "regulatory contract." *See Winstar*, 116 S. Ct. at 2454-55 (plurality opinion).

[14/]The Chief Justice, joined by Justice Ginsburg, dissented on the ground that the unmistakability doctrine applied and was not satisfied.

The regulated entities in *Winstar* had made massive investments in reliance upon a particular regulatory policy. The central question in the case, however, was the very one which the LECs ignore: whether the policy relied upon was a *contractual* commitment by the government to the regulated thrifts, or whether the government's representations were simply statements of then-current policy which regulators were free to change.

In resolving this issue, the Court looked to the specific evidence of a contract. Based on the evidence, the Court found that the acquisition agreements treated the regulators' supervisory goodwill policies as part of the agreement, not merely statements of law. The Court emphasized the economic reality of the transaction, which was that without the right to count supervisory goodwill toward capital reserves, each of the acquiring thrifts would have been instantly insolvent and subject to federal takeover as soon as the acquisition was completed. Under those circumstances, the Court suggested that it would have been "madness" not to make the necessary accounting treatment a binding part of the relevant agreements. *See* 116 S. Ct. at 2449-50 (plurality opinion). Justice Scalia's concurring opinion relied further on the fact that this accounting treatment was the *only* consideration that the Government gave in exchange for the acquisition of the failed thrifts -- an action which greatly benefited the FSLIC and the Bank Board. Hence, Justice Scalia argued, to treat the accounting consideration as nonbinding would render the Government's promise wholly illusory. 116 S. Ct. at 2477.

Unlike the LECs' "regulatory contract," then, the *Winstar* transactions were self-consciously contractual in nature (with express written terms), and the government's alleged obligation was the *only* consideration on one side. The LECs, by contrast, have pointed to no documents executed between them and the FCC that purport to *be* contracts, and, in particular, none that guarantee them a right to recover their historical costs *as part of an agreement between the parties*. Moreover, the LECs will be unable to make the illusory promise argument relied upon by Justice Scalia; after all, even TELRIC pricing provides *some* consideration to the LECs, and contract law on *adequacy* of consideration is notoriously lenient, so long as some consideration exists at all. *See, e.g, Restatement (Second) of Contracts*, § 79 & cmt. c.

E. The LECs' "regulatory contract" argument has no limiting principle.

From a broad policy perspective, the greatest weakness in the LECs' claim of a regulatory contract is that it proves too much. If the LECs have a contractual interest in a particular regulatory regime, it is not clear how change can ever be accomplished without paying damages. Surely, AT&T had certain expectations in the 1970s as to whether it was required to permit resale, or whether it was going to permit interconnection to competitors such as MCI, or whether customers could own their equipment. In each instance, the Commission adopted a policy which substantially altered the regulatory structure, and cost AT&T several billion dollars. Yet such changes were not found to violate any regulatory contract.

These examples illustrate the fundamental problem with the Sidak and Spulber argument: they attempt to force the square peg of regulation into the round hole of contracts. The only way to preserve the distinction between these two instruments of government policy is to eschew contract analysis in the absence of some manifest intent to be bound on the regulator's part. The LECs have shown no such intent here, and their "regulatory contract" argument should accordingly be rejected.

Respectfully submitted,

John Windhausen, Jr.

Ronald J. Binz, President
Debra Berlyn, Executive Director
John Windhausen, Jr., General Counsel

Competition Policy Institute
1156 15th St. N.W. Suite 310
Washington, D.C. 20005

Gerard J. Waldron
Ernest A. Young
Covington & Burling
1201 Pennsylvania Ave., N.W.
P.O. Box 7566
Washington, D.C. 20044-7566